REMEDIES – HOW DO YOU SPELL RELIEF?

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I. **Introduction**

The paramount goal of tax administration is to determine the taxpayer's correct amount of tax for the year, taking into account all of the facts and the arguments offered by both sides.[1] However, concepts such as jurisdiction, exhaustion of administrative remedies, and other intervening matters such as the subsequent determination that a tax statute is unconstitutional, may offer obstacles to the taxpayer and the taxing agency in reaching this optimum goal. The purpose of this paper is to summarize and discuss current remedies under the California Franchise and Income Tax law, identify areas in which current remedies may be inadequate, and address competing concerns in considering potential solutions.

II. **Summary of Current Remedies**

A. Deficiency Procedures

1. **Notice of Proposed Assessment**. If the Franchise Tax Board (FTB) determines that the tax reported on an original or amended return is less that that determined as the result of an examination, the FTB will issue a Notice of Proposed Assessment (NPA). (Revenue and Taxation Code sections 19033 and 19034) Also, if a taxpayer fails to file a return or files a false or fraudulent return, at any time, the FTB may make an estimate of the taxpayer's net income from available information and may issue an NPA. (Revenue and Taxation Code section 19087)

If taxpayers do not agree with an NPA, they have the right to protest the proposed assessment by filing a written protest with the FTB within sixty (60) days from the date the NPA was mailed. (Revenue and Taxation Code section 19041)

2. **Protest**. A proposed assessment becomes final 60 days after the FTB mails the NPA, unless the taxpayer files a written protest against the proposed additional tax within such time. (Revenue and Taxation Code section 19041) Protests are considered by the FTB staff. If a request for an oral hearing is made in the protest, FTB staff will conduct an oral hearing. (Revenue and Taxation Code section 19044) In closing the protest case, the FTB will issue a Notice of Action (NOA), which will affirm, revise or withdraw the NPA. (Revenue and Taxation Code sections 19044, 19045) The FTB action on the protest becomes final 30 days after the FTB mails the NOA, unless the taxpayer files a

1 See, Senate Bill (SB) 445, (Stats. 2001, Ch. 670), chaptered October 10, 2001, which amends Revenue and Taxation Code section 21002, to state in pertinent part, "The Legislature further finds and declares that the purpose of any tax proceeding between the Franchise Tax Board and a taxpayer is the determination of the taxpayer's correct tax liability. It is the intent of the Legislature that, in the furtherance of this purpose, the Franchise Tax Board may inquire into, and shall allow the taxpayer every opportunity to present, all relevant information pertaining to the taxpayer's liability."

written appeal of the action to the California State Board of Equalization (SBE) within such time. (Revenue and Taxation Code section 19045)

If taxpayers do not file a protest within this 60-day period, the proposed assessment becomes final, and they will receive a bill for any tax, penalties, fees, and interest owed. They must pay the billed amount, but if they do not agree that they owe this amount, they may then file a claim for refund.

3. **Administrative Appeal to the SBE**. If taxpayers disagree with the action taken on a protest of an NPA, they may file an appeal with the SBE within 30 days from the date the NOA was mailed. (Revenue and Taxation Code section 19045) The SBE hears and determines the appeal and notifies the taxpayer and the FTB of its determination. (Revenue and Taxation Code section 19047) The SBE's determination becomes final upon the expiration of 30 days from the time of the determination unless within the 30-day period, the taxpayer or the FTB files a petition for rehearing with the SBE. (Revenue and Taxation Code section 19048) In that event, the determination becomes final upon the expiration of 30 days from the time the SBE issues its opinion on the petition. (Revenue and Taxation Code section 19048)

B. Claim for Refund Procedures

1. **Refund Claim**. If a taxpayer wishes to obtain a refund of an overpayment, the taxpayer must file a claim for refund. (Revenue and Taxation Code section 19322) The claim for refund must be in writing and may be made by way of an amended return or in correspondence. Claims for refund will be consider by FTB staff. There is no statutory right to a hearing on a claim for refund. However, California Code of Regulations, section 19322(d) provides that ,"a hearing may be arranged at such time and place as the Franchise Tax Board may determine if requested by the taxpayer."

After considering the refund claim, the FTB will issue a NOA, which will allow, partially allow, or deny the refund claim. If the FTB denies all or part of a claim for refund and the taxpayer does not agree, the taxpayer may file an appeal from the FTB's action. A written appeal must be filed with the SBE within ninety (90) days from the date the denial was mailed. (Revenue and Taxation Code section 19324)

In addition, if, with or after the filing of a protest or an appeal to the SBE, a taxpayer pays the tax protested before the FTB acts upon the protest, or the SBE upon the appeal, the protest or the appeal is converted into a claim for refund or an appeal from the denial of a claim for refund. (Revenue and Taxation Code section 19335)

2. **Administrative Appeal to the SBE**. If the FTB denies all or part of a claim for refund and the taxpayer does not agree, an appeal may be filed with the SBE within 90 days from the date the NOA was mailed. (Revenue and Taxation Code section 19324) If the FTB fails to mail notice of action on any refund claim within six months after the claim is filed, the taxpayer may, prior to mailing of notice of action on the refund claim,

consider the claim disallowed and appeal to the SBE. (Revenue and Taxation Code section 19331)

The SBE hears and determines the appeal and notifies the taxpayer and the FTB of its determination. (Revenue and Taxation Code section 19333) The SBE's determination becomes final upon the expiration of 30 days from the time of the determination unless within the 30-day period, the taxpayer or the FTB files a petition for rehearing with the SBE. (Revenue and Taxation Code section 19334) In that event, the determination becomes final upon the expiration of 30 days from the time the SBE issues its opinion on the petition. (Revenue and Taxation Code section 19334)

3. **Litigation**. If the FTB denies all or part of a claim for refund and the taxpayer does not agree, the taxpayer may file an action in court. (Revenue and Taxation Code section 19382) The action must be filed within the later of: four years from the last day prescribed for filing the return, one year from the date the tax was paid, or within 90 days after (a) notice of action by the FTB upon any claim for refund, or (b) the determination (including the issuance of a decision, opinion, or dismissal) by the SBE on an appeal from the action of the FTB on a claim for refund becomes final pursuant to Revenue and Taxation Code 19334. (Revenue and Taxation Code section 19384)

If the FTB fails to mail a notice of action on a refund claim within six months after the claim was filed, the taxpayer may, prior to the mailing of notice of action on the refund claim, consider the claim disallowed and bring an action in court against the FTB on the grounds set forth in the claim. (Revenue and Taxation Code section 19385)

C. California Government Claims Board (Board of Control)

1. **Types of Claims**. If a taxpayer is unsuccessful in an appeal before the SBE, and has no other legal remedy, the taxpayer may file an "equity claim" with the Victims Compensation and Government Claims Board ("Government Claims Board," formerly referred to as the "Board of Control"). (California Government Code section 905.2) This type of claim commonly involves matters that are beyond the time limits for filing a legal claim or the claimant is entitled to reimbursement, but either there is no appropriation or payment, or the appropriation has expired and the funds have reverted. Typically, in relation to tax matters, these involve refund claims which are barred by the statute of limitations and stale dated warrants. Other issues handled by the FTB include child support collections, DMV collections, and agency offsets.

2. **Procedure**. After receipt of a claim, Government Claims Board staff reviews it to ensure that it meets the legal requirements established under the Government Code. If the claim meets all of those requirements, the Government Claims Board staff refers it to the involved state agency for review and recommendation as to the merits of the claim. The state agency may either recommend that the Government Claims Board reject, approve in full, or partially approve the claim.

The Government Claims Board will reject a claim if it raises factual and/or legal issues that are too complex for informal resolution, which it determines are more appropriately resolved in a court of law. When the Government Claims Board rejects a claim, it advises the claimant that he or she has six months from the date of the final Government Claims Board action notice to pursue a lawsuit against the state agency that allegedly caused the claimant's losses or damages.

Following the receipt and review of the involved state agency's response, Government Claims Board staff prepares a recommendation and presents it to the three-member Government Claims Board at a public meeting, during which the Board hears and acts on the claim. Written confirmation of the Government Claims Board's decision is sent to the claimant two weeks following the meeting and a copy is sent to the involved state agency. Government Claims Board-approved equity claims are included in one of two omnibus claims bills that are submitted to the Legislature annually. Once the Legislature and the Governor approve the claims bills, the Government Claims Board makes payment to the claimant. However, the Legislature and Governor may still delete a claim from a claims bill. In such instances, the Government Claims Board notifies the claimant that his/her claim was deleted and that he/she may initiate court action against the state agency.

a. **Query**: Requirement that administrative remedies be exhausted – on cases where the law is clearly in favor of the taxing agency, the claimant still must pursue administrative remedies (ex., file an appeal with the SBE after the FTB denies refund claim) before the claimant can go to the Board of Control. Should this be changed?

D. Alternative Dispute Resolution Mechanisms

1. **Settlement**

Revenue and Taxation Code section 19442 authorizes the FTB to settle civil tax matters in dispute that are the subject of protests, appeals, or refund claims. The FTB's Settlement Bureau is responsible for the negotiation of settlements of civil tax matters in dispute. The purpose of the settlement program is to negotiate settlements of civil tax matters in dispute consistent with a reasonable evaluation of the costs and risks associated with the litigation of these matters. The settlement program is intended to provide taxpayers with an expedited method of resolving civil tax matters in dispute.

See, FTB Notice 2001-03 for procedures on submitting a settlement offer. If accepted for settlement, administrative appeals are deferred for pending settlement efforts. Agreements generally reached in settlement within 9 months.

2. **Offers in Compromise/Installment Agreements**

FTB's Offer in Compromise (OIC) program is for taxpayers who do not have, and will not have in the foreseeable future, the income, assets or means to pay their tax liability. It allows a taxpayer the ability to offer a lesser amount for payment of a non-disputed final tax liability.

In order for the FTB to process an OIC application, the taxpayer must file all of the required tax returns, fully complete the OIC application, provide all supporting documentation, and agree with the FTB on the amount of tax owed.

Generally, the FTB will approve an OIC when the amount offered represents the most the FTB can expect to collect within a reasonable period of time. Each case is evaluated based on its own unique set of facts and circumstances. However, the following factors are given strong consideration in the evaluation: the taxpayer's ability to pay ; the amount of equity in the taxpayer's assets; the taxpayer's present and future income; the taxpayer's present and future expenses; and the potential for changed circumstances.

On occasion, the FTB may require a taxpayer to enter into a collateral agreement for a term of five years. Generally, a collateral agreement will be required in cases when the taxpayer has significant potential for increased earnings. A collateral agreement requires a taxpayer pay to FTB a percentage of future earnings that exceed an amount agreed upon by the taxpayer and FTB.

In addition to the FTB's OIC program, the FTB also has an installment agreement program for financial hardships. As a condition for approval of an installment agreement, generally the taxpayer must agree to make monthly payments through electronic funds transfer (EFT). By requesting an installment agreement, the taxpayer must also agree to meet all the taxpayer's future tax liabilities, including having adequate withholding or estimated tax payments so that tax liability for future years is paid in full when the return is timely filed. If the taxpayer does not make payments on time or has an outstanding past due amount in a future year, the taxpayer may be in default on the agreement, and the FTB may take enforcement action to collect the entire amount owed. Any state tax refund due the taxpayer will be applied to the total amount owed, but will not replace the monthly payment. Interest continues to accrue until the balance is paid in full.

3. **Meditation/Arbitration**

Mediation is beginning to emerge as a useful alternative in California tax litigation matters. Mediation is a non-binding, confidential process in which a neutral third party directs settlement discussions, but does not render judgment regarding any issue in dispute. The use of mediation, in appropriate cases, can result in a more efficient use of judicial and taxing authority resources. It can be utilized when other standard settlement procedures have failed.

Fact-based cases appear to lend themselves more readily to mediation. The FTB staff has had success in mediating several residency litigation cases. The advantage to a mediation conference in place of a regular settlement conference is that the parties may pick a mediator who has experience in tax.

Mediation is also part of an alternative dispute resolution mechanism used by the Multistate Tax Commission (MTC). This involves the voluntary participation by taxpayers and states to resolve tax disputes which involve more than a single state. This is a cost effective way to resolve interstate tax disputes. It also allows the taxpayer to bring a dispute which involves several states before one body for resolution so that it will be resolved in a consistent manner. However, one difficulty which arises is the taxpayer's need to keep the actions viable in each of the states.

There has been limited experience with arbitration at the state level.

III. **Potential Limitations On Current Remedies**

A**.** Statute of Limitations. Generally, a taxpayer must file a refund claim within four years of the original due date, or four years from the actual filing date of a return filed on or before the extended due date, or within one year of the date of overpayment, whichever is later. (Revenue and Taxation Code section 19306) California law does not provide for the waiver of the statutory period based on reasonable cause or extenuating circumstances. A taxpayer's failure, for whatever reason, to file a claim for refund within the statutory period prevents the taxpayer from doing so at a later date. (*Appeal of Richard M. and Claire P. Hammerman*, Cal. St. Bd. of Equal., December 13, 1983.)

1. California law does not currently provide for **equitable tolling** of the statute of limitations based on a taxpayer's incapacity in income tax cases. (*Appeal of Earl W. and Patricia A. McFeaters*, 94-SBE-012, November 30, 1994.) The IRS (IRC section 6511(h)) and the SBE (Revenue and Taxation Code section 6902.4(c)) do have financial disability/equitable tolling provisions.

The judicial doctrine of equitable tolling was held not to apply to tax cases in *Mercury Casualty Co. v. State Board of Equalization* (1986) 179 Cal. App.3d 34, 40, 224 Cal.Rptr. 781 and *Shiseido Cosmetics (America) Ltd. v. Franchise Tax Board* (1991) 235 Cal.App.3d 478, 489, 286 Cal.Rptr. 690.)

2. **Disaster Extension/military**. California substantially conforms to Internal Revenue Code sections 7508 and 7508A which allow most administrative acts to be postponed for military service in a combat zone and following a Presidentially-declared disaster. Acts that can be effective beyond the normal time limit include the filing of refund claims, protests, appeals and bringing suit. (Revenue and Taxation Code sections 18570-18572.)

3. **Statute of limitations on claims following a final federal determination**. A taxpayer has two years after the final federal determination to file a refund claim resulting from the federal adjustment. (Revenue and Taxation Code section 19311) Individuals no longer are required to notify FTB of federal changes if the changes do not increase the amount of tax. For final federal determinations after 1/1/2000, corporations are now required to report all federal changes, but failure to do so does not affect the time period for filing a refund claim.

As originally enacted, under Revenue and Taxation Code section 19311, the FTB could not determine and allow a refund following a federal determination in the absence of a formal claim for refund by the taxpayer. Recent legislation in SB 1185, (Stats. 2001, Ch. 543) chaptered October 5, 2001, amends Revenue and Taxation Code section 19311 to permit the FTB to allow a credit, make a refund, or mail a notice of proposed overpayment resulting from a final federal determination, within two years of the federal determination

a. **Query:** what is a claim "resulting from a final federal determination?"

4. **Barred Offset/Equitable Recoupment**. Two doctrines often come into play in the statute of limitations area where an adjustment or determination has consequences for different tax years or to related taxpayers: the barred offset provisions in Revenue and Taxation Code section 19314 and the doctrine of equitable recoupment.

The **barred offset** provision in Revenue and Taxation Code section 19314 provides that any overpayment due a taxpayer for any year shall be allowed as an offset in computing any deficiency in tax for the same year or any other year if the overpayment results from a transfer of income and/or deductions (1) to or from another year for the same or related taxpayers or (2) between affiliated corporations for the same year or for different years. The offset is only available if a claim is filed or the FTB has approved a credit within four years of the return due date without regard to any extension of time or one year from the date of the overpayment, whichever period expires later, and in no case, after more than seven years from the due date of the return for which the overpayment is determined.

This barred offset provision is properly applied in cases where there is an actual transfer of income from one year to another, such as where a theft loss is determined to be deductible in the year of discovery rather than the year of the theft as claimed on the return. In that case, FTB would propose a deficiency in the year that the loss was improperly claimed. If the statute of limitations for filing a refund claim had expired for the proper year of the loss, the taxpayer could assert the barred offset provisions on protest or appeal, and the deficiency amount could be reduced by the amount of the barred overpayment under section 19314. Note that the adjustment is made to the deficiency amount for the tax year of the deficiency.

The barred offset provision is commonly asserted incorrectly in tax shelter or routine federal adjustment cases, where the deficiency results from a disallowance of one type of deduction, for example partnership losses or depreciation deductions, and the barred refund results from the corresponding reduction to a different type of income, such as capital gain from the sale of the depreciated asset or the partnership interest.

The doctrine of **equitable recoupment** is based primarily on two United States Supreme Court decisions, *Bull v. United States* (1935) 295 U.S. 247 [79 L.Ed. 1421], and *Stone v. White* (1937) 301 U.S. 532 [81 L.Ed. 1265]. In *Bull*, the Court granted the taxpayer equitable relief in the nature of recoupment of taxes paid, despite the fact that an action for tax refund was barred by the statute of limitations. The Court justified its holding by reasoning that it was unjust to tax the same fund of money or taxable event twice on inconsistent theories, and then to deny recovery of the incorrect tax. The doctrine of equitable recoupment is a narrow case law exception to the statute of limitations, where the application of the statute would work a palpable injustice. The courts have narrowly limited the doctrine's application to avoid seriously undermining the statute of limitations. (*Rothensies v. Electric Storage Battery Co.* (1946) 329 U.S. 296, 302 [91 L.Ed 296, 300-301]; *Kolom v. U.S.* (9th Cir. 1986) 791 F.2d 762, 767.) Equitable recoupment is limited to the case where "a fund of money arising from the same taxable transaction or event has been taxed twice on inconsistent legal theories to the same taxpayer." (*Rothensies v. Electric Storage Battery Co.* 329 U.S. at 300; *Kolom v. U.S., supra*, 791 F.2d at 767.)

5. **The raising of new issues by the government or the taxpayer during administrative proceedings**. After the completion of an audit and the issuance of an NPA, or after the filing of a formal refund claim, a "new issues" problem might arise. The raising of a new issue is most problematic when the statute of limitations for issuing an assessment, filing a refund claim or filing a protest has passed.

For example, as a general rule, the consideration of the protest of a proposed assessment, or the evaluation of a refund claim, is limited to the "grounds" or general issue/s raised in either the NPA or the claim. However, during the protest or administrative claim process, either the taxpayer's representative or the state may discover something (unrelated to the original adjustment), materially affects the computation of the proper tax amount for the year.

a. **Deficiencies**

Revenue and Taxation Code section 19034 requires FTB to set forth the reasons for a proposed deficiency assessment on the notice. This requirement is fairly broad, and a notice will not be found to be invalid if the taxpayer was not prevented from adequately protesting the assessment. (See *Appeal of Edison California Stores*, Cal. State. Bd. of Equal., May 18, 1950.) However, if during the protest or appeal process, FTB discovers an alternate ground for sustaining the assessment, in general that alternate ground may be used, but the burden of proof may shift to FTB to sustain the assessment.

The SBE's approach on appeal to determining what is a new issue is somewhat unclear.

In *Appeal of Jenkel-Davidson Optical Company*, Cal. St. Bd. of Equal., May 19, 1981, the FTB issued NPAs which reflected FTB's determination that the entire corporate group was conducting a unitary business and recomputed the California source income of the appellant using the standard three-factor apportionment formula. FTB also questioned the propriety of the deduction by the subsidiaries of a pro rata share of the parent's overhead expenses as fees for management services. However, no adjustment was proposed at that time because the payments were treated as intercompany eliminations on the combined report and had no tax effect. The taxpayer protested, and as a result of the protest, the FTB concluded that the appellant was not part of the unitary business. FTB then issued a Notice of Action (NOA), revising the original assessments to reflect this determination as well as the disallowance of the deduction claimed for management services fees. On appeal, the appellant argued that the assessments were barred by the statute of limitations. In dismissing the appellant's argument, the SBE stated:

> The problem with appellant's argument is that the so-called new assessments which appellant complains of as being untimely were not new assessments at all. Rather, they were merely respondent's notices of action in which the original timely assessments were revised. Where notices of proposed assessment were issued within the statutory period, the fact that notices of action were not issued within the four-year period is irrelevant. (Citation omitted.)
>
> As a result of appellant's successful protest in which it was concluded that appellant was not part of the unitary business, it was necessary to revise the original assessments to reflect this determination as well as the disallowance of the deduction claimed for management services fees. The resulting revised determination was reflected in the notices of action issued March 14, 1978, which resulted in reducing the original proposed assessments.
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> Accordingly, we must conclude that respondent's assessments for the appeal years were timely and are not barred by the statute of limitations.

The SBE seems to tie the new issues concept closely to federal tax court rules and holdings defining what is a "new matter." In the *Appeal of David G. and Helen Mendelsohn*, Cal. St. Bd. of Equal., November 6, 1985, FTB's original NPA disallowed certain bad debt deductions, apparently conceding that the debts were bad debts, but based on the theory that the debts were nonbusiness in nature. On appeal, FTB discovered that the amounts had been previously deducted in a prior year, and abandoned its nonbusiness arguments. The SBE followed Tax Court cases and found that as FTB has raised a new theory on appeal that went beyond simple clarification or development of its original position, FTB had the burden to present new evidence in support of its position. As FTB did not do so, the SBE found that FTB had failed to satisfy its burden of proof.

In *Appeal of Sierra Pacific Industries*, Cal. St. Bd. of Equal., January 5, 1994, the SBE considered whether a new issue was raised in the Notice of Action (NOA). The SBE seemed to initially analyze the situation by considering: (a) whether appellant had notice of the issue; (b) whether it was part of the same transaction; and (c) whether it was merely clarifying the issue set forth in the NPA to more accurately reflect the facts of the transaction. Because it determined that the NOA with the alleged “new issue” was timely issued, the SBE apparently did not consider the item in question to be a new issue. The SBE also discussed in *Sierra Pacific* whether the FTB raised a “new matter” under federal tax court rules with respect to a sale and leaseback transaction. The new matter inquiry was made for purposes of determining where the burden of proof should lie with regard to this issue. Under Tax Court rules, a new matter is one which: (a) alters the original deficiency or results in a larger deficiency (had the FTB adopted it initially) or (b) requires the presentation of new evidence. Moreover, if a new theory merely clarifies or develops the original determination without being inconsistent or increasing the amount of the deficiency, it is not a “new matter.” (See, e.g., *Zarin v. Commissioner* (1989) 92 T.C. 1084; *Achiro v. Commissioner* (1981) 77 T.C. 881; *Appeal of David G. and Helen Mendelsohn*, Cal. St. Bd. of Equal., November 6, 1985.) Under the facts of the case, the SBE in *Sierra Pacific* concluded that a new mater had not been raised, and therefore the burden or proof did not shift to the FTB.

Based on *Mendehlson* and *Sierra Pacific*, the major inquiry for SBE purposes seems to be what is a “new matter” under federal Tax Court rules. The SBE has not defined what is a “new issue” (i.e., new grounds or new reasons). Unlike the courts, the SBE does not address the question of whether a new issue can be introduced, but rather assumes it can be (except in a claims setting; see discussion infra), and the SBE’s concern to date has been limited to who bears the burden of proof with respect to an item. There is a possibility that the SBE’s approach may change in the future because the SBE has never discussed Revenue and Taxation Code sections 19034, 19041, and 19045 in this context, and there is no California statutory authority adopting federal Tax Court rules.

b. **Claim for refund**. In a claim for refund setting, the general rule is that a refund claim throws open the taxpayer's entire tax liability for the period in question, and the state may raise issues unrelated to the basis or theory on which the taxpayer is seeking a refund in order to defeat the claim. (*Citicorp North America, Inc. v. Franchise Tax Bd.* (2000) 83 Cal.App.4th 1403, 1422, citing *Title Ins. Co. v. State Bd. of Equalization* (1992) 4 Cal.4th 715, 732 and *Sprint Communications Co. v. State Bd. of Equalization* (1995) 40 Cal.App.4th 1254, 1260.)

However, once a claim has been denied, the SBE has determined that a new issue cannot be raised after the statute of limitations for filing a claim has run. In *Appeal of Beneficial Californi*a, 96-SBE-001, February 22, 1996, the SBE decided that a new issue could not be raised and stated as one of its reasons: “Because of [taxpayer’s] failure to properly apprise respondent of these issues, there has been no opportunity to develop the facts necessary for either respondent or this board to evaluate these items.” The SBE also considered the facts that (1) respondent had stated in its opening brief that factual unity was not at issue and the appellant did not object; (2) appellant raised the new issues only a month before oral hearing; (3) there was no opportunity for the FTB to develop facts or the SBE to evaluate the issues; (4) there was no reason why the appellant would not have plainly stated the arguments in the claim and that specificity was lacking.

(i) **Query**: Should FTB conform to federal procedure? Taxpayers exercising their pre-payment remedy in U.S. Tax Court must waive the statute of limitations on deficiency assessments, effectively allowing new deficiency assessments to be made any time during the process. California could adopt similar provisions, keeping the statute of limitation open during administrative protest and appeal procedures. Alternatively, California could partially adopt the federal process, but cap the potential amount in controversy at the refund or NPA amount.

(ii) **Alternatively**, California could amend its law to provide for changes to the existing system, perhaps allowing an administrative appeal to be returned to protest status for further factual development where one of the parties seeks to raise a new issue.

B. <u>Exhaustion of Administrative Remedies</u>

1. **Claim for Refund Requirements**. A claim for refund must be in writing, signed by the taxpayer or authorized representative and state the specific grounds upon which it is based. (Revenue and Taxation Code section 19322) The claim should set forth sufficient detail about the grounds and facts so that the FTB is apprised of the exact basis of the claim. (California Code of Regulations section 19322)

In the recent case *Heather Preston* v. *State Board of Equalization* (2001) 25 Cal. 4th 197, the California Supreme Court explained that the corresponding requirement under the Sales and Use Tax Law that specific grounds be stated in the original claim is to ensure that the government receives sufficient notice of the claim and its basis so that any mistakes can be corrected during the administrative process, thereby conserving judicial resources. (See also *Jimmy Swaggart Ministries v. Bd. of Equalization of Cal.* (1990) 493 U.S. 378, at 392, 106 L.Ed.2d 796; aff'g. 4th Dist., 204 Cal.App.3d 1269, 250 Cal.Rptr. 89 1988; *United States Steel Corp*. v. *Franchise Tax Board* (1983) 144 Cal.App.3d 473, 480; and *Shiseido Cosmetics (America) Ltd. v. Franchise Tax Board* (1991) 235 Cal.App.3d 478, 489.)

The court in *Preston*, *supra,* reaffirmed the basic judicial principles of exhaustion of administrative remedies: the (original) claim for refund "frames and restricts the issues for litigation" and that "courts are without jurisdiction to consider grounds not set forth in the claim." Nevertheless, the court found that under the particular facts of the case presented, the language of the original refund claim asserting that the "right of reproduction" should not be treated as a sale was sufficient to raise the issue that the sales were of nontaxable copyrights. The unstated contention was clearly implied from a contention expressly stated in the claim and so was sufficiently stated for purposes of exhaustion. (*Preston*, *supra*, at 206, citing *Wallace Berrie & Co. v. State Board of Equalization* (1985) 40 Cal.3d 60, 66; *Montgomery Ward v. Franchise Tax Board* (1970) 6 Cal.App.3d 149, 164-165)

2. **Deemed Denial** - ***Geneva Towers* issue**. (*Geneva Towers Limited Partnership v. City and County of San Francisco* (2000) 81 Cal. App. 4th 658, rev. granted September 27, 2000 (S090136), reported at: 2000 Cal. LEXIS 7483.) This case has implications for the deemed denial provisions (Revenue and Taxation Code sections 19331 (appeal with SBE) and 19385 (litigation)).

The appellant taxpayer, Geneva Towers, became the owner of a low-income housing project in 1987. The change in ownership led to a reassessment of the base-year value, and Geneva Towers appealed the assessment, receiving slightly more than a 50% reduction in the assessment. Believing it was entitled to an additional amount, Geneva Towers filed a claim for refund with the Board of Supervisors in November of 1991. There was no evidence that the Board ever acted on the claim. In January, 1999, Geneva filed a lawsuit against respondent, City of San Francisco, California, seeking a refund of excess taxes. The trial court sustained respondent's demurrer to appellant's complaint without leave to amend. The appeal presented a question of first impression regarding the time period for filing a tax refund lawsuit under Revenue and Taxation Code section 5141(b), when the Board of Supervisors failed to act on the underlying tax refund claim. On appeal, the court affirmed the dismissal asserting that section 5141(b) did not contain a limitation period, and that as a result, California Civil Procedure Code section 343 controlled. Under this provision, the taxpayer was required to commence a suit within four years after the cause of action accrued.

(a) **Query**: Should this rule apply in all situations? What about the "protective claim" situation where the taxing agency has received the taxpayer's refund claim, but the taxpayer requests that no action be taken pending related federal action or other litigation?

C. Jurisdiction and Standing Issues

1. **Full Payment Rule**. Necessity of payment of amounts other than tax prior to administrative proceedings/litigation.

In *Agnew v. State Board of Equalization* (1999) 21 Cal. 4th 310, 87 Cal.Rptr. 2d 423, the California Supreme Court dealt with the question of whether the full payment rule required the payment of tax and interest before a suit for refund could be brought under the Sales and Use tax law. The Supreme Court concluded that the full payment rule only requires the payment of tax, and not the interest. In the case of *Roy Chen v. Franchise Tax Board* (1999) 75 Cal. App. 4th 1110, 1121-1122, 90 Cal.Rptr.2d, 268, the court held that the same holding applied to a case involving income tax, stating, "Both article XIII, section 32, and section 19382 provide that payment of the *tax* is a prerequisite to a refund action. In its plain, ordinary, and commonsense meaning, 'tax' means tax. It does not mean interest. If the Legislature meant to include accrued interest as well as tax, it would have said so."

(a) **Query**: What if only penalties are at issue? The *Agnew* and *Chen* cases leave this open. The *Chen* opinion does discuss a number of cases where there is language suggesting that penalties are part of the tax.

(b) **Query**: Should the *Agnew* decision apply to administrative proceedings?

In addition, recently enacted Assembly Bill (AB) 1115, (Stats. 2001, Ch. 920) chaptered October 14, 2001, provides for an informal refund claim process, tolling the statute of limitations for up to seven years while the taxpayer is making payments of tax due. It adds new Revenue and Taxation Code section 19322.1, which states:

(a) A claim for refund that is otherwise valid under Section 19322, but that is made in the case in which payment of the entire tax assessed or asserted has not been made, shall be a claim only for purposes of tolling the time periods set forth in Section 19306. For all other purposes (including the application of Sections 19323, 19324, 19331, 19335, 19384, and 19385) the claim shall be deemed filed on the date that full payment of the tax is made. However, no credit or refund may be made or allowed for any payment made more than seven years before the date that full payment of the tax is made.
(b) This section shall apply to all claims for refund filed on or after the effective date of the act adding this section, without regard to taxable year.

2. **Res Judicata** – In the case of *Pope Estate Co. v. Johnson* (1941) 43 Cal.App.2d 170, 174, 110 P.2d 481, the court held that:

> A suit for recovery of the whole or a portion of tax for a particular year throws open refund throws open all questions relating to the same tax year. Neither the tax collecting authorities nor the taxpayer are at liberty to split up the question and prosecute in the courts the question as to liability for that year piecemeal. The rule is quite absolute in its character and applies so as to prevent a second action in the courts involving a particular year's liability even though the facts upon which the second suit rests occurred after the first was decided.

In California administrative proceedings, the rule of *res judicata* only applies where the same **issue** has been previously considered and decided. There is no prohibition on multiple assessments and/or refund claims on different issues as long as the statute of limitations is open. See *Appeal of Reitz Manufacturing Co.*, Cal. St. Bd. of Equal., Feb. 28, 1984; *Appeal of Kenneth R. Waldroff*, Cal. St. Bd. of Equal., Nov. 14, 1979. Once the statute of limitations has passed however any amendment of a claim must involve the same issue to be considered (see "new issues" discussion above.)

3. **Second Claim on Same Issue** - As noted above, where final action has occurred on a claim, the filing of a second claim on the same issue is a nullity. See the *Appeal of Frank*

Joseph Rossiter, Cal. St. Bd. of Equal., January 5, 1982. This is true even where there is an intervening change in the law due to a judicial decision or legislative act. (Angelus Milling Co. v. Commissioner (1945) 325 U.S. 293.)

4. **Suspended/Nonqualified Corporations**. Suspended corporations may not prosecute, bring or maintain an appeal before the SBE. (*Appeal of Atlantic and Pacific Wrecking Co., Inc*., Cal. St. Bd. of Equal., July 22, 1958; *Appeal of Western Miracle Water Softener, Inc*., Cal. St. Bd. of Equal., Oct. 13, 1959; *Appeal of Celeron Realty Corporation*, Cal. St. Bd. of Equal., Aug. 7, 1963.) In *United Medical Management Ltd. v. Gatto* (1996) 49 Cal.App.4th 1732, 1741, the Court of Appeal reiterated the importance of a foreign corporation qualifying with the Secretary of State, prior to commencing an action in the state court, "the purpose of the certificate of qualification is to facilitate service of process and to protect against state tax evasion. [Citation omitted.] . . . The qualification statute is enforced, in part, by temporarily halting lawsuits. The objective of the lawsuit suspension enforcement mechanism is to encourage qualification, rather than to penalize. . . ."

(a) **Query**: What should be done in cases where the taxpayer provides evidence which establishes the taxing agency's assessment is incorrect? Should the taxpayer be required to revive before the taxing agency will revise the assessment?

In *Appeal of Al Tirpa & Associates, Inc.,* 97-SBE-007, February 26, 1997, the SBE held that a nonqualified foreign corporation (i.e., one failing to obtain a certificate of qualification to transact intrastate business in California from the Secretary of State) may not exercise the right to bring an administrative appeal before the SBE. In *Appeal of Reitman Atlantic Corporation*, 2001-SBE-002, May 31 2001, the same issue was presented. In *Reitman*, the FTB asked the SBE to reconsider its conclusion in *Al Tirpa*, and contended that a distinction should be made between suspended domestic corporations and nonqualified foreign corporations. The FTB argued a nonqualified foreign corporation may not have anticipated a filing obligation in California through its actions, and thus not knowingly violated such a filing obligation. The nonqualified foreign corporation should thus be able to seek a ruling from the SBE to determine its disputed filing obligation. In its opinion, the SBE agreed with the FTB's argument and stated that "to preclude a nonqualified foreign corporation from commencing an administrative appeal before this Board because it has not qualified with the Secretary of State is contrary to the statutory scheme found in the Corporations Code and the R&TC, as well as the weight of judicial opinion. To the extent our decision in *Al Tirpa* conflicts with our conclusions here, it will not be followed."

IV. **Illustrative Hypotheticals**

V. <u>**Remedy for Unconstitutional Taxes - Part I**</u>

A STATE'S OBLIGATION TO REFUND UNCONSTITUTIONAL TAXES
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The United States Supreme Court has ruled that, if a state passes an unconstitutional tax, it must provide a remedy under state law which meets constitutional due process requirements

Remedy Options:

Refund the entire tax paid
Refund the difference between what petitioner paid and what its competitors paid
Assess and collect back taxes from competitors to create a non-discriminatory scheme
Refund the amount that petitioner absorbed and did not pass through to customers
Compensate petitioner for competitive disadvantage caused by tax

Acceptable State Limitations:

Require petitioner to prove actual damages
Choice of remedy determined by state law
Short statute of limitations
Strict procedural requirements for refund claims.

Measure of Damages:

Although most petitioners seek a refund of all the taxes they paid, so long as state law determines the remedy, they are engaging in wishful thinking. Getting a refund of the difference between what they paid in taxes and their in-state competitors paid is also highly unlikely, given the likely financial impact on the states. And, given the political and economic realities, no state is likely to assess and collect back taxes from in-state competitors to create a non-discriminatory scheme. That leaves us with the solution most states have adopted: refunding the amount of the unconstitutional tax that the petitioner absorbed and providing compensation for the competitive disadvantage caused by the unconstitutional tax.

The United States Supreme Court determined in *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, (1984); *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco, Department of Business Regulation*, 496 U.S. 18 (1990); and *James B. Beam Distilling Co. v. Georgia*, 501 U.S. 529 (1991) that the issue of remedy for an unconstitutional tax was a question of state law so long as the remedy met the due process requirements of the Constitution. Although the Supreme Court itself ruled on the remedy available under Florida law in *McKesson*, traditionally it remands the issue back to the states, *See e.g. Bacchus*, *Armco v. Hardesty*, 467 U.S. 638 (1984) and *Beam*. The states then held evidentiary proceedings to give the taxpayers a chance to prove how much of the unconstitutional tax they had absorbed and to prove any competitive injury they had sustained. This rule has most recently been adopted by the State of Illinois for compensating insurance companies which paid a tax which violated the State Constitution. *Milwaukee*

Safeguard Insurance Co., et al. v. Selcke, et al.; No. 1-00-1973; No. 1-00-1979 (17 Jul 2001). Tax Analysts Document Number: Doc 2001-19571 (19 original pages) Tax Analysts Electronic Citation: 2001 TNT 139-7. In order to redress competitive disadvantage, retroactive refund relief should focus on the "actual damage" or "injury" caused by the tax. The Supreme Court has implicitly approved such an approach in the case of unconstitutional state taxes,[2] and affirmatively held that it is the only legitimate measure of relief for constitutional torts. In *Memphis Community School District v. Stachura*, 477 U.S. 299 (1986) the Court recognized that when:

> plaintiffs seek damages for violations of constitutional rights, the level of damages is ordinarily determined according to principles derived from the common law of torts.... damages in tort cases are designed to provide "compensation for the injury caused to plaintiff by defendant's breach of duty".

Id. at 306. Since this is the remedy that federal courts presumably have to provide in actions under 42 U.S.C. §1983 against state taxes which violate the Commerce Clause[3], it would be difficult to argue that such a state remedy would violate due process.[4]

Because most lawyers have difficulty understanding economists,[5] the following is a "simple" explanation of the process most states have used to determine how much of a refund is

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[2] *Beam*; *Bacchus*, 468 U.S. 263, 276-278 (1984). "Although the taxpaying appellants prevailed on the merits of the Commerce Clause claim, however, the *Bacchus* Court did not grant their request for a refund of taxes paid under the law found unconstitutional. Instead we remanded the case for consideration of the State's arguments that appellants were `not entitled to refunds since they did not bear the economic incidence of the tax but passed it on as a separate addition to the price that their customers were legally obligated to pay.' *Bacchus*, 468 U.S. at 276-277, 82 L Ed2d 200, 104 S Ct 3049." *Beam* at 538. "` These refund issues.... essentially issues of remedy,' had not been adequately developed on the record nor passed upon by the state courts below, and their consideration may have been intertwined with, or obviated by, matters of state law. *Id*., at 277." *Beam* at 539.

[3] See *Dennis v. Higgins*, 498 U.S. 439 (1991), holding that states can be sued under 42 U.S.C. § 1983 for taxes which violate the Commerce Clause.

[4] The "actual damage" or "injury" approach should appeal to those members of the Supreme Court who have recognized that the states may factor in equitable considerations in designing a refund remedy. See *James B. Beam Distilling Co.*, 501 U.S. at 543 ("... nothing we say here precludes consideration of individual equities when deciding remedial issues in particular cases"); *American Trucking Association v. Smith*, 496 U.S. at 224 (dissent). Moreover, those members of the Court dissatisfied with *Beam*'s apparent rejection of equitable considerations in determining retroactivity may be more sympathetic to state efforts to limit their liability through remedy mechanisms, given the financial distress of the states, the relative equities and the current state of economic theory. "To impose on Georgia and the other States that reasonably relied on this Court's established precedent such extraordinary retroactive liability, at a time when most States are struggling to fund even the most basic services, is the height of unfairness." *Beam* at 558 (dissent).

owed to each taxpayer. It is a two step process: determining the amount of absorption and then the amount of competitive injury caused by the unconstitutional tax.

The least expensive way[6] for a state to determine how much of the unconstitutional tax was absorbed by a taxpayer is to ascertain what the absorption rate was for each affected industry and then give individual taxpayers whose absorption rate is greater than the average for their industry an opportunity to provide specific evidence of their individual absorption rate. It is not be an easy task. However, since many corporations already have this data, it offers states a chance to efficiently provide the taxpayers their constitutionally mandated refunds without generating windfalls at the expense of their citizens.

How much of a tax was absorbed by the taxpayer and not passed-through to its customers typically is determined by what economists call "tax incidence analysis". This is the analysis adopted by the Department of Energy's Office of Hearings and Appeals in *The Stripper Well Oil Overcharge Case* when it was asked by the U.S. District Court in Kansas to determine how much of the billions of dollars of crude oil overcharges was absorbed by oil refiners and how much was passed on the consumers. CCH Federal Energy Guidelines ¶ 90,507 (1985). After about 6 weeks of hearings and over 24,000 pages of testimony and exhibits from some of the nation's leading economists and statisticians, the Office of Hearings and Appeals concluded that incidence analysis, while it can be complex and time-consuming, provided the best estimate of cost pass-through. And, since a tax, like crude oil, is a cost, the analysis is equally applicable to the tax area.

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5 One explanation may be that most economists seem incapable of uttering a simple declarative sentence without beginning, "assuming no taxes and perfect competition the following will occur."

6 "`[T]he Government's interest ... in conserving scarce fiscal and administrative resources is a factor that must be weighed' when determining precise contours of process due." *McKesson*, 496 U.S. at 51, quoting *Mathews v. Eldridge*, 424 U.S. 319, at 348 (1976).

Incidence analysis examines supply and demand conditions in the marketplace to determine who bore the burden of the cost (tax) increase.[7] The standard formula used for computing cost absorption by firms in an industry is given by dividing the absolute value of the price elasticity of demand[8] by the sum of the absolute values of the price elasticity of demand and the price elasticity of supply,[9] shown as follows:

$$A = \frac{Ed}{Ed + Es}$$

where:

A = absorption of a cost increase by a producing firm
Ed = industry price elasticity of demand
Es = industry price elasticity of supply

The result of this formula is a fraction or percentage which indicates the percentage of the cost increase absorbed by the producing firm. The complementary of the absorption fraction is the "pass-through" fraction or the percentage of the cost increase passed on to consumers.

Although this formula is relatively easy to apply and compute, deriving or obtaining estimates for the price elasticities of demand and supply may be quite difficult. In some cases the public economics literature provides relevant estimates of demand and/or supply elasticities which may be used to estimate absorption and pass-through fractions. Nevertheless, estimating elasticities is not an exact science. The results are influenced by the availability of data, proper specification of the econometric models, and interpretation of the results. Thus, even in situations in which estimates of demand or supply elasticities may be known, they must be used and interpreted with caution which is why administrative hearings are so useful in developing a record.

The second step in determining the amount of the refund is to determine whether the unconstitutional tax caused any competitive harm to the out-of-state taxpayers. Here one must examine changes in market share of out-of-state producers compared with in-state producers. If

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[7] This analysis assumes a competitive market in which the laws of supply and demand mandate that the amount of the cost increase will be roughly equal for all firms in the industry. However, it is possible to do the same kind of analysis for non-competitive markets and for individual taxpayers, if one has more specific data.

[8] The price elasticity of demand is defined as the percentage change in the quantity demanded for a given percentage change in price. Although this may seem a difficult concept, it is really very simple. Elasticity of demand compares the response of purchasers to a change in price. This is usually expressed as a ratio. If purchasers make no response to any price change, elasticity is said to be zero. On the other hand, if a price change provokes an infinitely large change in purchases, the elasticity of demand is infinite.

[9] The price elasticity of supply measures the response of producers to a change in price, i.e. the percentage change in output for a given percentage change in price.

out-of-state producers lost market share to in-state producers then sales levels, profit rates and unit profit margins must be examined to determine what competitive harm the out-of-state taxpayers suffered. Of course, where there is no in-state production, there is no competitive harm and no damages.

Although it may be impossible to determine to the penny the precise injury suffered by the taxpayers from an unconstitutional tax, such precision is not required by the Constitution. What is required is a good faith attempt by a state to redress its wrong to the taxpayers by giving the taxpayers an opportunity to establish their actual damages without unduly burdening the entire state population.[10] Economics gives the states the tools to accomplish this and they must be prepared to use these tools to provide the "clear and certain remedy" to which taxpayers are entitled.[11]

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[10] *McKesson*, 496 U.S. at 40, n. 23.

[11] *McKesson*, 496 U.S. at 40.

VI. **<u>Remedy for Unconstitutional Taxes – Part II</u>**

WHEN CONSTITUTIONAL LAW CLASHES WITH FAIRNESS AND GOOD POLICY: REMEDIES FOR UNCONSTITUTIONAL STATE TAXES

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I. States have long defended against constitutional challenges to their taxes not only on the merits but also on the basis that if successful, the taxpayer would be entitled to no remedy or a seriously compromised one. Indeed, after each of the following landmark United States Supreme Court cases striking down state taxes, *McKesson, Fulton, Hunt-Wesson, and South Central Bell,* the state mounted an all-out effort to avoid paying full refunds to the winning taxpayers (or to impose retroactive taxes upon taxpayers not even involved in the lawsuit), albeit with limited success. In other instances, however, states have succeeded in retaining unconstitutional taxes or increasing the taxes of non-party taxpayers, raising grave fairness and policy issues. As courts sanction this approach, what might have they sacrificed?

II. Overview

A. Two overarching considerations largely govern a taxpayer's remedy for a successful constitutional challenge to a tax: federal constitutional law regarding remedies, and state law regarding statutory construction and remedies.

B. Federal constitutional law establishes the broad parameters governing any remedy ultimately pronounced by a state.

1. The seminal case regarding remedies for unconstitutional taxes is *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco,* 496 U.S. 18 (1990). In *McKesson,* the state courts held that Florida's liquor taxing scheme discriminated against interstate commerce by allowing a tax exemption for alcoholic beverages produced from products commonly grown in Florida. Nevertheless, the state courts refused to allow a refund or any other form of relief for the taxes already paid. McKesson appealed, arguing that it was entitled to a refund at least equal to the difference between the tax imposed upon the favored and the disfavored products. The U.S. Supreme Court held that prospective relief alone did not satisfy due process standards, and stated that if the state does not afford predeprivation relief, the Due Process Clause requires the state to provide "meaningful backward-looking relief" to mend the constitutional deprivation. Id. at 31.

2. Although *McKesson* is most properly viewed as addressing the threshold issue of whether a taxpayer who successfully challenged a tax is entitled to retroactive relief, the case nevertheless has virtually single-handedly shaped the landscape of what remedy is required where the taxpayer is entitled to retroactive relief.

3. *McKesson* establishes that the underlying defect in the taxing scheme initially will drive what remedy is required to cure it. The Court stated that where a tax is invalid "either because (other than its discriminatory nature) it was beyond the State's power to impose . . . or because the taxpayers were absolutely immune from the tax," the state must "'undo' the unlawful deprivation by refunding the tax previously paid under duress . . . ." *Id.* at 39. For example, if a state had a statute that circumvented constitutional nexus requirements, the tax imposed under that statute would be considered beyond the state's power to impose. Presumably, then, the only available remedy under *McKesson* would be a full refund of the tax paid under the unconstitutional statute.

4. Regarding discriminatory taxes, the Court afforded more flexibility for the proper remedy. If a tax is struck down as discriminatory, the state "may cure the invalidity . . . by refunding to petitioner the difference between the tax it paid and the tax it would have been assessed were it extended the same rate reductions that its competitors actually received." *Id.* at 40. Alternatively, "the State may assess and collect back taxes from [the favored class]. . . calibrating the assessment to create in hindsight a nondiscriminatory scheme." *Id.* Finally, the state also may cure discrimination through "a combination of a partial refund to petitioner and a partial retroactive assessment of tax increases on favored competitors . . . ." *Id.*

5. The Court held that, where the state opts to assess the previously favored class retroactively, "the State's effort to collect back taxes. . . may not be perfectly successful. . . . Some [taxpayers], for example, may no longer be in business. But a good-faith effort to administer and enforce such a retroactive assessment likely would constitute adequate relief, to the same extent that a tax scheme would not violate the Commerce Clause merely because tax collectors inadvertently missed a few in-state taxpayers." *Id.* at 41.

C. Once a statute has been held unconstitutional, state law comes into play in determining which of the foregoing options are feasible and the extent to which they should be employed. Among some state rules that may impact the crafting of remedies for unconstitutional statutes are: severability and/or reformation laws and savings clauses; refund statutes; legislative remedies created after a holding that a statutory scheme is unconstitutional; statutes of limitations for assessing back taxes; and statutes providing generally what remedy is required if a statute is held unconstitutional. Indeed, state law could well be determinative in tailoring the required remedy. For example, once a court determines that a state tax was beyond the state's power to impose, state law may determine the manner in which the appropriate refund should be computed. Or, if a court determines that a state tax discriminates against interstate commerce, state law may govern whether a partial or full refund is warranted, whether back taxes should be imposed on the previously favored class, or whether a hybrid remedy is appropriate.

III. The application and interplay of federal constitutional law and state law regarding remedies

A. Following is a discussion of a number of cases that demonstrate the application and interplay of certain state law principles with federal constitutional law. This will set the stage for the final discussion regarding the underlying policy concerns in the approach taken by many courts when fashioning remedies for unconstitutional state taxes.

B. Severability and specific language of refund statutes.

1. *Annenberg v. Commonwealth of Pennsylvania,* 757 A.2d 338 (Pa. 2000), *cert. denied*, 121 S. Ct. 385 (Oct. 30, 2000) (No. 00-343), illustrates the role that a state's severability rules and refund statutes may play in fashioning specific remedies. Pennsylvania's personal property tax statute generally allowed counties to tax shares of stock of foreign corporations owned by a resident of the state, but precluded counties from taxing shares of stock in corporations liable for or relieved from Pennsylvania's capital stock or franchise tax. Because the capital stock and franchise taxes were imposed only upon corporations incorporated in Pennsylvania or doing business within the state, the Pennsylvania Supreme Court held that the taxing scheme unconstitutionally discriminated against resident shareholders of foreign corporations that did not conduct business within the state.

2. The taxpayers argued that a refund was required for two reasons. First, they claimed, the relevant Pennsylvania refund statute required it. Second, they asserted, the entire personal property tax statute had to be stricken because, among other reasons, severing only the offending language would produce a scheme that the Legislature never intended. Regarding legislative intent, the Legislature had recently rejected a bill which would have extended the personal property tax to all classes of stock. The taxpayers argued that in doing so the Legislature communicated that it did not desire the tax on stock to apply to all classes of stock, which would have been the effect of severance.

3. The Pennsylvania Supreme Court rejected the taxpayers' arguments and denied a refund. The court first concluded that the Pennsylvania refund statute, which provides

that a refund is due whenever a political subdivision of the state collects taxes to which it was not "legally entitled," did not apply. The court reasoned that only the exclusion to the stock tax was unconstitutional, and, therefore, the taxes imposed upon the plaintiffs were collected legally. Moreover, the court held that, under Pennsylvania law, the offending language was severable, thereby leaving the rest of the tax statute intact. The court then rejected the taxpayers' argument that the legislative intent could be gleaned from the acts of a subsequent Legislature. Rather, the court was limited to "examining what the enacting legislature would have done had it known that the exemption it placed in the stock clause was unconstitutional." *Id.* at 21. Apparently concluding that the Legislature would have enacted the tax without the exclusion, the court determined that the exclusion was severable.

4. Having determined that the county was "legally entitled" to the taxes collected, the court held that a refund was inappropriate, but did not dictate a specific remedy. Rather the court remanded the case, acknowledging that *McKesson* requires some retroactive remedy to rectify the discrimination. The taxpayers petitioned the U.S. Supreme Court for a writ of certiorari arguing that it was not appropriate for the Pennsylvania Supreme Court to remand this case, because the only constitutionally permissible remedy was a refund. The U.S. Supreme Court denied the taxpayers' request for review. *See Annenberg v. Commonwealth of Pennsylvania,* 757 A.2d 338 (Pa. 2000), *cert. denied*, 121 S. Ct. 385 (Oct. 30, 2000) (No. 00-343).

5. Thus, *McKesson* required the state to provide the *Annenberg* taxpayers "meaningful backward-looking" relief, which could be achieved in a variety of ways, including a refund or retroactive taxation. But it was the state law that narrowed the appropriate remedy. Had the offending language not been severable under Pennsylvania law, the entire tax statute might have been struck down, and the taxpayers likely would have received a full refund.

6. Following the remand, earlier this year Montgomery County informed 82,000 taxpayers it was planning to collect the tax on "previously exempt stock for the four years in question." However, the county agreed not to collect anything *if* the taxpayer agreed not to pursue any refund. Essentially, then, since virtually all taxpayers are either in a refund or assessment position, the ones in an assessment position would be expected to send back the waiver (which is meaningless to them), relieving the county from assessing them back taxes (again meaningless); and taxpayers in a refund position would not do anything, but they wouldn't receive refunds. The county court subsequently upheld the plan even though it didn't actually create equality between the favored and disfavored classes (since the favored class wasn't actually assessed back taxes).

7. State law doctrines and statutes such as severability led to the remedy following *Hunt-Wesson v. Franchise Tax Board,* 120 S.Ct. 1022 (2000), in which the U.S. Supreme Court struck down California's interest offset statute as applied to non-domiciled taxpayers. Rev. & Tax. Code § 23057 provides:

> If any chapter, article, section, subsection, clause, sentence or phrase of this part which is reasonably separable from the remaining portions of this

> part, or the application thereof to any person, taxpayer or circumstance, is for any reason determined unconstitutional, such determination shall not affect the remainder of this part, nor, will the application of any such provision to other persons, taxpayers or circumstances, be affected thereby.

"[T]his part" means Part 11 (Bank and Corporation Tax Law) of the Rev. & Tax. Code, which includes the interest offset statute. In light of this section, following *Hunt-Wesson,* the FTB was required to construe the interest offset statute to apply in all circumstances which were not found to be unconstitutional by the Supreme Court. This certainly included applying interest offset to domiciliary taxpayers. It also included applying interest offset so long as nontaxable nonbusiness income was not converted to taxable business income. Taking these considerations into account, the FTB members indeed construed the interest offset provision to apply to domiciliary taxpayers, as well as to provide a full interest deduction against apportionable business income for nondomiciliary taxpayers (except that this may not hold true for taxpayers that have made a water's-edge election). *See* FTB Notice 2000-9.

8. However, very recently the state's Legislative Counsel called into question the constitutionality of the FTB's remedy. The Legislative Counsel did not even cite Rev. & Tax. Code § 23057. Though it did cite a similar provision, Rev. & Tax. Code § 26, it failed to apply the language that if the "application to any person or circumstance" of a statute "is held invalid, the remainder of the code *or the application of the provision to other persons or circumstances*, is not affected." (Emphasis supplied.) While we believe the Legislative Counsel's view is wrong, it still may provide the FTB Staff with a basis for bringing the issue before the FTB members again and seeking reversal of FTB Notice 2000-9.

C. Legislative remedies created after a holding that a statutory scheme is unconstitutional.

1. Another case at the vanguard of the remedies issue, *W.R. Grace & Co. v. State of Washington, Department of Revenue,* 973 P.2d 1011 (Wash. 1999), *cert. denied*, 528 U.S. 950 (Oct. 18, 1999) (No. 99-38), demonstrates the role of a statute passed specifically to remedy a tax that already had been held unconstitutional. Washington imposed a Business and Occupation ("B&O") tax on the privilege of doing business in the state, including manufacturing and making wholesale sales. Though the same tax rates applied to both activities, under Washington's "multiple activities exemption," local manufacturers enjoyed an exemption from the manufacturing tax for any portion of their output that was subject to the tax on wholesale sales. However, no credit was allowed for taxes paid on sales outside of Washington.

2. After the B&O tax was held to discriminate against interstate commerce because the "multiple activities exemption" discriminated against out-of-state manufacturers who sold their products within the state, as well as against in-state manufacturers who sold their products out of state, *see Tyler Pipe Indus. Inc. v. Department of Revenue,* 483 U.S. 232 (1987), the Washington Legislature enacted the Multiple Activities Tax Credit ("MATC"). Under the MATC, taxpayers paying the selling tax may take a credit against the tax for any manufacturing tax paid to Washington or any equivalent tax paid to

another state. Taxpayers paying a manufacturing tax and selling out of state can take a credit against that tax for any selling tax paid to another state on the same product.

3. In order for an interstate taxpayer to receive a credit under the MATC, it has to, among other things, identify manufacturing or selling activities in another jurisdiction, trace individual ingredients or products from the manufacturing state to Washington, and maintain extensive records during the tax years in question. Unfortunately, since the MATC was enacted retroactively, and taxpayers had no independent reason to keep such records, many taxpayers engaged in interstate transactions find it impossible to establish a right to a credit. On the other hand, taxpayers engaged in intrastate transactions receive the credit automatically.

4. According to the taxpayers in *W.R. Grace*, due to the burdens imposed by the MATC, which created a likelihood of receiving no credit at all, the MATC did not afford them "meaningful backward-looking" relief. They also challenged the MATC on discrimination and fair apportionment grounds, and claimed that retroactive application of the MATC violated due process because it interfered with taxpayers' settled expectations and because it was applied too far back in time.

5. Recognizing that under *McKesson* states are afforded flexibility in fashioning remedies, the Washington Supreme Court dismissed the taxpayers' discrimination and apportionment challenges, stating that those issues had been resolved in prior cases. The court purported to rely on *McKesson* as authority for the state legislature modifying an offending tax statute retroactively to rectify the constitutional defect, though *McKesson* does not appear to state this explicitly. Thus, the court held that the MATC constituted the proper remedy in this case, and that neither a refund, nor any other type of additional relief, was required. The court never addressed directly the taxpayers' allegations that the MATC did not provide a true remedy. At least the dissent acknowledged that "as a practical matter, the in-state taxpayer enjoys an automatic 100 percent credit whereas the interstate taxpayer is lucky to recoup 1 percent, if that." *Id.* at 1032 (Sanders, J., dissenting).

6. One of the more interesting questions arising from the *W.R. Grace* litigation is: assuming that a retroactive legislative remedy is permissible in general, would such a remedy be subject to any limitations? *W.R. Grace* does not itself suggest any limits. However, as discussed further at the end of this article, giving legislatures unfettered discretion to craft remedies for unconstitutional statutes is potentially rife with problems.

D. Statutes of limitations for assessing back taxes and general remedies statutes.

1. Lest taxpayers think they never will receive a refund of unconstitutional taxes, the court in *Ceridian Corp. v. Franchise Tax Bd.,* 85 Cal. App. 4th 875 (2000), ordered a full refund of all unconstitutional taxes. *Ceridian* illustrates how a state's statute of limitations on imposing back taxes plays a role in a court's analysis of the remedies issue. And, it provides an example of a state statute dictating generally the remedy for unconstitutional taxes.

2. After holding unconstitutional California's statute regarding deductions for dividends received from insurance companies, the court in *Ceridian* stated that "the parties agree that retroactive tax collection in this case is impossible, since the tax years in question are 1978-1982, and the statute of limitations for assessment or collection of a tax deficiency is four years." *Id.* at 889. Thus, solely because the years in question were not within the 4-year statute of limitations, the court affirmed the trial court's holding requiring a refund for the constitutional violation in question.

3. Whereas the years in *Ceridian* were quite old, challenges to the statute in *Ceridian*, as well as a similar statute (Cal. Rev. & Tax. Code § 24402), no doubt will arise for years that are within the normal 4-year statute of limitations. The court in *Ceridian* did not address the remedy issue under those circumstances stating that "only Ceridian's refund claim is before us. Accordingly, we express no general opinion regarding the appropriate remedy in other cases. . . . " *Id.* at 889, n.9. Certainly, the FTB will argue that the proper remedy in cases where the years in question still are within the 4-year statute of limitations is assessing back taxes on the favored class. Moreover, the state likely will rely on *McKesson's* language that the state's efforts to impose back taxes need not be perfect, and that only "a good-faith effort [is necessary] to administer and enforce [ ] a retroactive assessment. . . ." *McKesson*, 496 U.S. at 41. Unfortunately, *McKesson* provides no guidance regarding what may or may not constitute a "good-faith effort."

4. In *Ceridian,* the state also relied on a general remedies statute, Cal. Rev. & Tax. Code § 19393, in an attempt to avoid paying a refund. Section 19393 provides in relevant part that if a deduction under the corporate income and franchise tax is held invalid on constitutional grounds, the tax liability of the favored taxpayer shall be recomputed, disallowing the deduction. The state argued that section 19393 required the state to remedy discrimination by increasing the tax of the favored taxpayers through disallowing the deduction that was held to be discriminatory rather than affording a refund. The trial court had concluded that section 19393 applied only to discrimination against national banks. However, the Court of Appeal declined to address the scope of section 19393, stating that "even if [it] is broad enough to cover Ceridian, it cannot provide the constitutionally required relief in this case [because the applicable statute of limitations is closed for the years in question]." *Id.* The court concluded that "section 19393 violates a taxpayer's right to due process, where, as here, the retroactive assessment it provides cannot lawfully be collected. Accordingly, the trial court did not err by awarding Ceridian the stipulated refund." *Id.*

5. Had the statute of limitations been open, and had the court concluded that section 19393 applied to corporations other than national banks, the result likely would have been quite different. In any event, section 19393 raises some interesting questions: Can a state legislature legally limit court-ordered remedies for taxes violating the federal constitution? Is it appropriate for the legislature to prescribe a generally applicable remedy without knowing anything about the tax or why it was unconstitutional? Is it good policy?

6. Four months after the California Appellate Court determined 24410 was unconstitutional, the FTB staff recommended a the following remedy: extend the 24410

deduction to all taxpayers (regardless of domicile) for the closed income years, and eliminate the deduction for everyone for the open years. Thus, taxpayers that planned their finances in accordance with the way the FTB was administering 24410 would now owe millions of dollars in taxes both prospectively and retroactively. Of course, affected insurance companies (and others) were outraged. The FTB briefly discussed the topic at an open meeting in May and another closed meeting in June. However, today we still do not have any resolution. Indeed, just this month, 12 insurers signed an open letter to Dr. Connell calling on the FTB to resolve the uncertainty so they can plan their business affairs accordingly.

E. Other broader issues.

1. Other courts, while allowing a partial or full refund under *McKesson,* have invited states to advance alternative remedies, such as eliminating discrimination through retroactively taxing the previously favored class of taxpayers. For example, in *Scottsdale Princess Partnership v. Department of Revenue,* 958 P.2d 15 (Ariz. Ct. App. 1997), the court mandated that the state provide a partial refund of improperly collected taxes. It rejected the state's argument that discrimination should be cured by retroactively taxing the favored class of taxpayers and stated that such a remedy would be "harsh and oppressive." *Id.* at 21. However, the court also observed that the County never indicated that it would be willing to take the steps necessary for retroactive taxation and, so, it left open the possibility that retroactive taxation might be appropriate under other circumstances.

2. Similarly, following *Smith v. New Hampshire,* 692 A.2d 486 (N.H. 1997), on remand, the Merrimack County Superior Court stated that "the state has not suggested an alternative remedy [to a refund], such as a credit toward future taxes or a retrospective collection of taxes from those who had enjoyed the benefit of the unconstitutional exemptions." *Smith v. New Hampshire,* No. 95-E-059 (Merrimack Superior Court 2000), at p. 28.

3. Lurking in the background of all future remedies disputes will be an argument raised in the certiorari petition to the U.S. Supreme Court in *Annenberg*, namely that two post-*McKesson* decisions require a full refund of all unconstitutional taxes: *Reich v. Collins*, 513 U.S. 106 (1994), and *Newsweek, Inc. v. Florida Department of Revenue,* 522 U.S. 442 (1998). According to the plaintiffs, those cases clarified that "where a state has held out a clear and certain postdeprivation remedy—and that remedy is a refund—that form of meaningful backward-looking relief may not be taken away from the taxpayer 'in midcourse.'" Petition for Writ of Certiorari at 12, *Annenberg v. Commonwealth of Pennsylvania,* 757 A.2d 338 (Pa. 2000), *cert. denied*, 121 S. Ct. 385 (Oct. 30, 2000) (No. 00-343). The plaintiff in *W.R. Grace* made a similar argument in its petition for review to the U.S. Supreme Court. We are not aware of any cases extending *Reich* and *Newsweek* beyond the principle that a retroactive remedy is required to the notion of what actual remedy is required. However, when the U.S. Supreme Court finally grapples with this interpretation, we may find that it has some merit.

F. U.S. Supreme Court doctrine does not support the "pass on" defense to deny taxpayers refunds of unconstitutional taxes.

1. The "pass on" defense essentially provides that a successful taxpayer's remedy should be limited to the actual harm it can prove it suffered (*i.e.*, the tax absorbed by the taxpayer and compensation for any lost market share resulting from the unconstitutional tax).

2. The notion that taxpayers should not receive windfalls is an equitable argument based upon unjust enrichment principles. *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18 (1990), and subsequent cases, reveal the Supreme Court's aversion towards, if not repudiation of, equitable arguments by states attempting to deny taxpayers meaningful backward-looking relief. *See, e.g., Harper v. Virginia Dep't of Taxation,* 509 U.S. 86 (1993); *Reynoldsville Casket Co. v. Hyde,* 514 U.S. 749 (1995); *Dryden v. Madison County*, 522 U.S. 1145 (1998). At least one commentator has concluded that the Supreme Court's action in *Dryden v. Madison County* left "no doubt that any glimmering hope the states may have had of arguing equitable considerations as a grounds to deny taxpayer refund claims have now been snuffed out." Mark E. Holcomb, *U.S. Supreme Court Strengthens Taxpayer Refund Claims*, State Tax Notes, June 8, 1998, at 1847, 1851.

3. Recently, in *Milwaukee Safeguard Ins. Co. v. Selcke, Director,* 754 N.E.2d 349; (Il. Ct. App. 2001), the Illinois appellate court approved of the pass on defense to deny 66 insurance companies refunds of $75 million in tax held to be unconstitutional. The taxpayers have appealed to the Illinois Supreme Court.

4. Tax Executives Institute ("TEI") filed an amicus brief in support of the petition for leave to appeal in which it persuasively argued that the court's ruling regarding the "pass on" defense was erroneous. (Copy of the TEI brief is attached.)

a. In the brief, TEI points out that *McKesson* stated, "We reject respondents' premise that 'equitable considerations justify a State's attempt to avoid bestowing this so-called 'windfall' when redressing a tax that is unconstitutional because discriminatory." *McKesson,* 496 U.S. at 46-47. Indeed, as TEI argues, *Harper v. Virginia Dept. of Taxation,* 509 U.S. 86 (1993), not cited in *Milwaukee Safeguard*, confirms that *McKesson* rejected the pass-on defense as a matter of law, on "federal due process" grounds, in suits for refund of a discriminatory tax. Leaving to the Virginia state courts the crafting of an appropriate remedy, the Court in *Harper* cautioned that "State law may provide relief beyond the demands of federal due process [citing *McKesson*], *but under no circumstances may it confine petitioners to a lesser remedy,*" citing *McKesson's* rejection of the pass-on defense. *McKesson,* 509 U.S. at 102 (emphasis added).

b. TEI also argues that the court misapplied two cases, *United States v. Jefferson Electric Manufacturing Co.,* 291 U.S. 386 (1934), because it is distinguishable, and *James B. Beam Distilling Co. v. Georgia,* 501 U.S. 529 (1991), because the court quotes from it out of context.

c. Finally, TEI appropriately argues that if the "pass on" defense is ever to apply, it should be limited to transactional taxes because "allowing the pass-on defense in [non-transactional tax cases] would impose a complex and arduous analytical proof by the taxpayer that the economic burden was not passed on, further extending both the cost and time in recovering money that was unlawfully extracted from them by the State."

IV. Do certain of the recent decisions constitute bad tax policy?

A. Though it may be too soon to tell whether there are clear trends in the law regarding the approach courts are taking to remedies for unconstitutional taxes, several possible trends suggested by the cases discussed above are especially troubling to us.

B. First, there is the possible trend towards states successfully retaining unconstitutional taxes. If such a trend ensues, the deterrent effect upon taxpayer lawsuits could cause taxpayers to be left at the mercy of legislatures to enact constitutional taxing schemes. Moreover, the judicial power *and duty* to review the constitutionality of legislation could be diminished greatly. Beyond these policy considerations, there is a basic question of fairness raised by not refunding unconstitutional taxes to the taxpayers who brought the successful lawsuit.

C. Second, there is an even more unsettling possible trend towards imposing back taxes on taxpayers who were not parties to the constitutional challenge, whether in a discrimination case or otherwise. From a policy perspective, such an approach seems especially misguided. When states, apparently due to a desire to offset sizeable refunds by a new source of revenue, endeavor to collect back taxes from taxpayers that were not even parties to the litigation, the potential for further litigation by the newly assessed taxpayers is evident.

D. Third, there is a possible trend towards retroactively amending tax statutes or creating a remedy through legislation for past periods. This, too, raises serious policy quandaries. For example, if the Legislature attempts to cure a constitutional defect by amending the offending statute, but doesn't quite cure the defect, then another round of litigation must begin only to have the Legislature try again, and perhaps again. If a tax is retroactively replaced with a new tax, all planning that a taxpayer did may become moot. This affects decisions about how to structure one's business affairs. It also affects simple record keeping that the taxpayer would have undertaken (*i.e.,* to establish a tax liability or to secure a credit or other remedy) but didn't because it did not appear necessary under prior law. Another concern is whether states will be permitted to circumvent voter approval requirements in the guise of establishing a remedy for an unconstitutional tax.

E. The cases discussed above all purport to decide remedies issues on the basis of the language in *McKesson*. However, *McKesson's* discussion of remedies in fact was *dicta*. And, given the number of permutations that could and do arise in the context of remedies for unconstitutional state taxes, it is likely that the Court did not foresee clearly all of the ramifications of actually applying those principles in real situations. While it is appropriate for lower courts to use *McKesson's* language for guidance, conforming to state law as well, those courts must establish boundaries around such language in a manner that is sensible, fair, and promotes good policy. Though the policy concerns we have identified do not necessarily rise to the level of legal arguments binding on the state courts, we can only hope that courts will begin to see the broader effects of their decisions and use their authority in a responsible way, taking these considerations into account.